No. 14217.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

L. Glenn Switzer, *et al.*,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

Petition for Consolidated Review of Decisions of the Tax Court of the United States.

BRIEF FOR PETITIONERS.

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JURISDICTION.

This is a petition to review four decisions of the Tax Court of the United States entered October 5, 1953. These four decisions have been consolidated for review by this Court. [R. 88.]

The cases involve the income tax liability for the calendar years 1944 and 1945. [R. 81.] Notices of Deficiency with respect to those years were mailed to each of the petitioners on February 24, 1950 [R. 24]; each of said petitioners filed petitions for redetermination of the proposed deficiencies with the Tax Court on May 15, 1950. [R. 1.] The Tax Court of the United States has jurisdiction of such actions under the provisions of Sections 1101 and 272 of the Internal Revenue Code. Petitions for Review and an affidavit of service thereof upon counsel for respondent were filed January 4, 1954. [R. 3 and 81.]

The income tax returns of each of the petitioners for each of the years involved were filed with the Collector of Internal Revenue for the Sixth District of California at Los Angeles [R. 78 and 79], and a partnership return was filed with the same collector for each of those years. [R. 69 and 73.] Each of the petitioners is a resident of Los Angeles County in the State of California. [R. 4 and 82.] The United States Court of Appeals for the Ninth Circuit has jurisdiction to review these decisions of the Tax Court under the provisions of Section 1141 of the Internal Revenue Code. The pleadings showing the existence of the jurisdiction of the Tax Court [R. 4 and 12], and that showing the jurisdiction of the Court of Appeals for the Ninth Circuit [R. 81] are set forth in the transcript of record herein.

STATEMENT OF THE CASE.

Petitioners, L. Glenn Switzer and Howard A. Switzer, were partners during the years 1944 and 1945, doing business as such in Pasadena, California, under the firm name of Transit Mixed Concrete Company. [R. 23.] L. Glenn Switzer owned a two-thirds interest in said partnership constituting the community property of himself and his wife, petitioner Ida H. Switzer, under California law; Howard A. Switzer owned a one-third interest in said partnership constituting the community property of himself and his wife, petitioner Florence M. Switzer, under California law. [R. 23-24.] All of the income of the four petitioners in said years was derived from their community property ownership of said partnership interests. [R. 24.]

The partnership return of income and an individual income tax return for each of the petitioners were timely filed for each of said years, that is on or before March 15, 1945 and March 15, 1946, respectively. [R. 24.] A Notice of Proposed Deficiencies for 1944 and 1945 was mailed to each petitioner on February 24, 1950, more than three years, but less than five years, after the returns had been filed. [R. 24.]

The income tax deficiencies proposed in said notices resulted from additions to the partnership income in the amount of $20,489.80 for 1944 and $68,193.60 for 1945. When the added amounts are compared to the amounts reported by the partnership, they appear as follows, expressed as a percentage of the amount reported:

PARTNERSHIP PERCENTAGE OMITTED.

	1944	1945	
Partnership Gross Receipts	1.5%	3.9%	[R. 25]
Partnership Gross Income	5.32%	12.96%	[R. 24]
Partnership Net Income	147.01%	444.01%	[R. 24, 33]

Each of the petitioners omitted from his individual returns gross income equal to 5.32% and 12.96% of the gross income reported therein for 1944 and 1945, respectively, if his gross income includes his share of partnership gross income; but he omitted gross income equal to 147.01% and 444.01% of that reported for the respective years if his gross income includes only his share of the partnership net income.

The percentage of gross income omitted is the critical question in these cases, since the only basis upon which the position of the Respondent may be sustained is that the gross income omitted exceeds 25 per cent of that reported.* If it does, Section 275(c) of the Internal Rev-

*It was stipulated that the three-year period of limitations was not extended by the execution of a consent to such extension by any of the petitioners. [R. 65.] The Tax Court found that no part of the deficiencies determined against the petitioners was due to fraud [R. 26], and that the returns had been filed on time. [R. 24.] Thus, there is no other exception to the Statute of Limitations applicable.

enue Code allows a five-year period within which deficiencies may be assessed, and the respondent's Notices of Deficiency were timely. If the omissions do not exceed 25 per cent of the reported gross income, the basic statutory limitation period under Section 275(a) of the Internal Revenue Code bars the proposed assessments since the Notices of Deficiency were mailed more than three years after the filing of the returns.

A secondary question is presented only if this Court holds that the five-year period of limitations applies and the Notices of Deficiency were therefore timely. That second question is whether the evidence supports the Tax Court's finding [R. 27] that part of each of the tax deficiencies asserted against the two petitioners, L. Glenn Switzer and Howard A. Switzer, is due to negligence within the meaning of Section 293(a) of the Internal Revenue Code. On the basis of that finding, the Tax Court added that 5 per cent negligence "penalty" to the deficiencies asserted against these two petitioners. [R. 33.]

The Statute of Limitations question was raised in the Notice of Deficiency since the Respondent was required to show some exception to the normal limitation period. [R. 9.] This was designated as erroneous in the petition filed by the petitioners. [R. 4-5.] The negligence question was first raised by the allegations of the respondent in an amendment to his Amended Answer [R. 19], which allegations were denied by the petitioners in replies to the Amendment to the Amended Answer. [R. 20.]

SPECIFICATION OF ERRORS.

1. The Tax Court erred in holding that a partner's gross income includes only his share of partnership *net* income, rather than his share of partnership *gross* income. [R. 37.] As a result of this error it concluded that more than 25 per cent of the gross income reported by the petitioners had been omitted by them and that the five-year period of limitations under Section 275(c) of the Internal Revenue Code applied. [R. 37.]

2. The Tax Court erred in making the following findings of fact, which findings are not supported by the evidence:

> "a. Part of the deficiencies for each of the taxable years determined against the husbands (Petitioners L. Glenn Switzer and Howard A. Switzer) was due to negligence within the purview of section 293(a) of the Internal Revenue Code.
>
> "b. Each of the petitioners for each of the taxable years omitted gross income in excess of 25 per cent of the amount of gross income stated in his or her return, and the deficiencies were timely asserted within the five-year period provided by section 275(c) of the Internal Revenue Code." [F. of F., R. 27.]

3. The Tax Court erred in holding that the five per cent addition to the tax for negligence under Section 293(a) of the Internal Revenue Code is applicable with respect to petitioners L. Glenn Switzer and Howard A. Switzer. [R. 33.]

SUMMARY OF ARGUMENT.

I. The sole question presented in the principal issue here involved is whether a partner's gross income includes his share of partnership gross income, or only his share of partnership net income, for the purpose of Section 275(c) of the Internal Revenue Code.

II. Section 275(c), or identical predecessor subsections, have been included in the revenue laws for twenty years. Several cases have been decided concerning this subsection, but none is particularly helpful in deciding the present question. It is well established that the respondent has the burden of proof in a case of this type where he seeks to apply an exception to the normal period of limitations on assessment of income tax deficiencies. The question herein presented requires a consideration of a partnership under state law and, more particularly, the federal tax laws.

III. Under the state law applicable to the partnership in question, a partnership is not an entity but an association or aggregation of co-owners carrying on a joint business enterprise.

IV. Under the federal tax laws a partnership is similarly treated as an aggregation of its members, except in certain special situations for which the Internal Revenue Code prescribes specific rules to the contrary. Basically, each member of a partnership is considered, for income tax purposes, to be carrying on his share of the partnership business individually.

V. The foregoing concept of a partnership for tax purposes has been recognized in several court decisions, in rules and regulations promulgated by the respondent, and by legislation of the Congress of the United States. The Tax Court and the respondent have both held that a partner's gross income includes his share of partnership gross income in other situations.

VI. Recent reports by committees of both Houses of the Congress, in connection with the proposed Revenue Code of 1954, have stated that, under existing law applicable to the cases herein presented to this Court, a partner's gross income includes his share of partnership gross income for the purpose of Section 275(c). In other words, the Congress has clearly indicated that the intent behind Section 275(c) is consistent with the contention of the petitioners herein and not with that of the respondent.

VII. This Court need not consider the negligence penalties imposed by the Tax Court upon two of the four petitioners herein unless it affirms the Tax Court on the Statute of Limitations question. If this Court does affirm the Tax Court on that question, it must consider the negligence question. The respondent had the burden of proving the negligence alleged by him. He introduced no evidence of negligence. The Tax Court sustained the proposed penalties solely on the basis of the size of the discrepancies between the reported and the corrected taxable income of these petitioners. Such a conclusion is clearly erroneous and amounts to an automatic imposition of the penalty in the case of a substantial deficiency, irrespective of the reason for the deficiency.

VIII. In conclusion, a partner's gross income includes his share of partnership gross income. By reporting his distributive share of partnership net income in his individual return, in the manner required by the Internal Revenue Code and the respondent's regulations, a partner has *"stated in the return"* his share of the partnership gross income. In no other manner consistent with the law and the applicable regulations can he state in the return his gross income from partnership operations. Accordingly, Section 275(c) does not apply in these cases since 25 per cent of reported gross income was not omitted by any of the petitioners in either of the years. The proposed deficiencies are, therefore, barred by the three-year Statute of Limitations under Section 275(a) and the decisions of the Tax Court should be reversed.

In any event, the negligence penalties and the finding upon which they are based are without the support of any evidence presented to the Tax Court.

ARGUMENT.

I.

Introductory.

The principal question presented in these consolidated cases concerns the application of the Statute of Limitations on assessment of income tax deficiencies. The ordinary three-year period of limitations expired prior to the initiation by the respondent of the assessment process by the mailing of his Notices of Deficiency. Since no other exception to that ordinary Statute of Limitations is applicable, the respondent relies upon Section 275(c) of the Internal Revenue Code, which allows a five-year period for such assessment if it is found that the facts stated in that section exist.

Section 275(c) reads as follows:

> "(c) Omission from Gross Income.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

Since all of the income of the petitioners, as reported and as corrected, was derived from the partnership, the application of Section 275(c) requires a determination of the amount of gross income of the petitioners from the partnership. Simply stated, the question is whether the gross income of a partner includes his share of partnership gross income or his share of partnership net income.

If the Court determines that a partner's gross income is his share of partnership gross income, these petitioners omitted far less than the 25 per cent required for the application of Section 275(c); if the Court determines that a partner's gross income is his share of partnership net income, these petitioners omitted far more than the required 25 per cent, and the respondent, as well as the Tax Court, was correct.

An example may clarify the situation and explain the great difference in the percentage omitted resulting from the determination of this principal question. Let us assume the following hypothetical situation:

Partnership Gross Income	$100,000.00
Partnership Deductible Expenses	95,000.00
Partnership Net Income	$ 5,000.00

Each of the two equal partners would then have reported as his individual share of the partnership net income, the sum of $2,500.00 Carrying this example further, we may assume that there was omitted from partnership gross income the sum of $10,000.00. The individual would then have omitted gross income equal to 10 per cent of his reported gross income, or 200 per cent of his reported gross income, depending upon whether his gross income is his share of partnership gross income or his share of partnership net income.

The application of Section 275(c) would depend upon the answer to this question in the hypothetical example just as it does in these cases presented to the Court for review.

Incidentally, the income tax returns of the petitioners and the partnership information returns were received in evidence by the Tax Court as respondent's Exhibits "A" to "J," inclusive. Photostatic copies thereof are included in Transcript of Record herein. [R. 69-79.] These copies show that the returns were accepted and/or not investigated by the respondent. The inescapable conclusion is that the omitted income was discovered and disclosed to the respondent by the petitioners voluntarily, but that this discovery and disclosure did not occur until the three-year period of limitations had expired. There is no fraud involved in the factual background of these proceedings. The Tax Court so held. [R. 31.] No inference adverse to the petitioners in the solution of the principal question should be drawn from the fact that there were relatively minor errors in bookkeeping on the part of their large, active business organization during wartime, when it had gross annual receipts of $1,291,-937.40 and $1,797,680.57. While it may be said that these errors should have been discovered by the respondent, as well as by the petitioners, during the three-year period following the filing of the returns, the well-established purpose of statutes of limitations is to close the door on stale claims and prevent the assertion of liability for years long past. An *exception* to the basic period established by the Internal Revenue Code should be allowed *only* where the facts giving rise to the application of that exception are *clearly* established.

II.

History of Section 275(c).

Section 275(c) first appeared as a corresponding subsection in the Revenue Act of 1934. The committee report which accompanied the bill stated that the purpose of the new subsection was to deny the privilege of the ordinary three-year Statute of Limitations to "taxpayers who are so negligent as to leave out of their returns items of such magnitude" (more than 25 per cent of the gross income reported). [House Ways & Means Committee Rept., No. 704, 73d Cong. 2d sess., p. 35; also reported at Cum. Bull., 1939-1 (Part 2) 554, 580.]

Since this subsection provides an exception to the Statute of Limitations, the respondent carries the burden of proof necessary to establish the exception, as has been held by the Tax Court in *C. A. Reis v. Comm.,* 1 T. C. 9 (1942).

An examination of Section 275(c) discloses that the facts to be proved by the respondent to establish the application of that section are: (1) The amount of gross income stated in the return; (2) The amount of omitted gross income that was properly includible therein; and (3) The omitted gross income expressed as a percentage of that reported.

There have been several cases decided by the Tax Court and other courts concerning Section 275(c). Many of these cases have been concerned with a determination of gross income with respect to capital gains, how to treat certain expenditures, etc. Some of the cases have been concerned with the question of the amount of gross income stated in the return and whether items listed on a schedule attached to the return or in the return of a related taxpayer are stated in the return for the purpose of this subsection. With the exception of the decision of the Tax Court in these cases now before this Court, there has been no case under Section 275(c) that is in point or particularly helpful in arriving at the answer to the questions herein presented.

No specific statute or regulation defines gross income in this situation, although Section 22(a) does define gross income in an all-inclusive manner. The questions here require an examination of the nature of partnerships under state law and under federal tax law.

III.

Nature of a Partnership Under State Law.

In California as in most states, the common law concept of a partnership has been maintained. That concept is that a partnership is an aggregate of its members who operate the partnership business as co-owners. The Uniform Partnership Act has been adopted in California and incorporated in the Corporations Code. A partnership is defined thereunder as "an association of two or more persons to carry on as co-owners a business for profit." [Cal. Corp. Code, Sec. 15006(1).]

The Court of Appeals for the Second Circuit, speaking through Judge Learned Hand, has said:

> "The Uniform Partnership Act * * * did not, * * * make the firm an independent juristic entity. * * * (T)he Conference in 1911 after a very full discussion chose to retain the pluralistic notion of the firm, as the English chancellors had painfully worked it out from the bare common-law, which recognized only joint owners and joint obligors." [*Helvering v. Smith* (C. C. A. 2d, 1937), 90 F. 2d 590, 591.]

IV.

Nature of a Partnership Under Tax Law.

The law concerning the taxation of income derived from partnership operations has also adopted the aggregate theory as its basic principle. The initial section in that portion of the Internal Revenue Code dealing with partnerships provides:

> "Sec. 181. Partnership Not Taxable. Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

The following sections of the Internal Revenue Code provide very briefly for the special rules applicable in determining the income and income tax liability of partners. Only in very limited cases have exceptions been made in the basic aggregate concept of partnerships. For example, commercial custom and administrative convenience demand that the fiscal year and accounting methods adopted by the partnership as a commercial, though not legal entity, be recognized for tax purposes. The chaos resulting from the application of a different rule to a partnership consisting of several dozen members undoubtedly inspired this mechanical rule which is now set forth in Section 188. For the same reason the bookkeeping unit is realistically recognized in the requirement that a single information return be filed on behalf of all of the partnership members (Sec. 187), rather than that each member duplicate on his individual return all of the items of income, deductions and credits applicable to the partnership operation.

As stated in *United States v. Coulby* (D. C. Ohio, 1918), 251 Fed. 982, 984, aff'd *Per Curiam* (C. C. A. 6th, 1919), 258 Fed. 27:

> "The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence, and placed the individual partner's share of its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name."

The Board of Tax Appeals has also stated this well-settled principle of tax law as follows in *Goadby Mills v. Comm.,* 3 B. T. A. 1245, 1249 (1926):

> "In the enactment of section 218(a) Congress ignored for taxing purposes the existence of the partnership and framed the law so as to treat the gains and profits of the partnership as if they were gains and profits of the individual partners. Unlike a corporation, a partnership has no legal existence aside from the members who compose it; consequently, in order that the profits of the partnership might not escape taxation, Congress provided that its income should be taxed to the individual partners, the same as if they received it direct without the intervention of the partnership."

The Court of Claims has recognized this principle as follows in *Craik v. United States,* 31 F. Supp. 132, 133, 135 (1940):

> "An examination of the various income tax Acts, beginning with the first one of 1913, shows that Congress in the enactment of each of them intended to treat partnership income as though the distributive share of each partner therein had been received directly by the partner. (p. 133.) * * * We are

convinced that Congress intended that partnership income should be treated as though it had been received by the partners individually." (p. 135.)

In *Jennings v. Comm.* (C. C. A. 5th, 1940), 110 F. 2d 945, 946, the Court of Appeals for the Fifth Circuit has stated:

> "A partnership is recognized as an entity separate from the partners in bankruptcy proceedings, but not in income taxation.
>
> "The partnership return is for information, and to secure uniformity and save repetition in the individual returns. It ascertains each partner's gain and apportions it to him to be taxed, whether distributed or not. It does not transform his share in the gain."

V.

Partnership Under Specific Sections of the Internal Revenue Code.

Not only has the aggregate theory been recognized as the fundamental principle upon which our tax law treats partnership income, but that principle has been applied to several specific situations. While none of these authorities deals with Section 275(c), they each hold that in determining the character, the source and the amount of a partner's income, we must divide the partnership and treat each member's share of the income as if he had earned it individually.

In *Craik v. United States,* 31 F. Supp. 132 (1940), the Court of Claims held that a non-resident alien who was a member of a partnership engaged in business within the United States must be considered as being himself engaged in business within the United States to the extent of his interest in the partnership. The Court also held that the partnership income received from sources without the United States should be treated as if the non-resident alien partner had received it directly. Accordingly, his share of such income from without the United States is not taxable here.

In *Jennings v. Comm.*, 110 F. 2d 945 (1940), the Fifth Circuit held that a partner could deduct individual gambling losses to the extent of his gambling gains, including his share of gambling gains of the partnership. In other words, that Court disregarded the partnership in determining the nature of the income derived from the partnership.

Under the provisions of the Revenue Act of 1932, losses from the sale of securities were deductible only to the extent of the taxpayer's gains from sale of such assets. In the case of *Neuberger v. Comm.*, 311 U. S. 83 (1940), the Supreme Court held that an individual's gains from security transactions included his share of such gains realized by a partnership of which he was a member, thereby recognizing the aggregate nature of a partnership under income tax law.

In another situation the Second Circuit has clearly stated and applied this principle of tax law. Section 24(b)(1)(B) of the Internal Revenue Code prohibits any deduction in computing net income for losses from sales of property, generally, between an individual and his controlled corporation. Does this apply to sales by a partnership of which the stockholder is a member? The Code does not specifically provide an answer, but the Court of Appeals for that circuit held that losses on such sales were within that section. (*Comm. v. Whitney* (C. C. A.

2d, 1948), 169 F. 2d 562, cert. den. 335 U. S. 892.) At page 568 the Court said:

> "There is no doubt that generally speaking under the tax law we must approach the partnership as an association of individuals who are co-owners of its specific property * * *."

In the *Whitney* case, *supra,* the Court quoted with approval the following:

> "In too many instances the Treasury and the courts have shied away from the plain implications of the statutory scheme: an income tax imposed upon the partners as individuals. Basically, the tax law adopts the common law concept of the partnership as an aggregate of individuals operating the properties of the partnership as co-owners."
>
> Rabkin and Johnson, "The Partnership under the Federal Tax Laws," 55 Harv. L. Rev. 909, 949.

In still another situation the Third Circuit has applied this basic concept to a specific problem under the Internal Revenue Code. Section 502(f) provides that "personal holding company income," upon which the severe personal holding company corporate surtax is based, includes rent received by a corporation for the use of its property by an *individual* owning 25 per cent or more of the corporation's outstanding stock. Does rent received by a corporation under a lease of its property to a partnership composed of its shareholders come within the classification? Is a partnership's right to use property equivalent to the partners' right to use that property, for tax purposes? It was so held in *Randolph Products Co. v. Manning* (C. A. 3rd, 1949), 176 F. 2d 190. To the same effect, see *Western Transmission Corporation,* 18 T. C. 818 (1952).

In a recent case, the Tax Court has expressly recognized that a *partner's gross income includes his share of partnership gross income.* That case is *Harry Landau v. Comm.,* 21 T. C. ...., No. 50 (1953). The respondent has announced his acquiescence in that decision. [Int. Rev. Bull., 1954-24, p. 4.] That case involved the application of an exception to the normal Statute of Limitations under Section 3801 of the Internal Revenue Code and, more particularly, whether an item of the partner's gross income had been omitted. This depended upon whether his gross income included partnership gross or only partnership net income. The Tax Court held, contrary to the contention of the Commissioner, that a partner's gross income includes his share of partnership gross income, just as the petitioners in this case are contending. In that case, in which the decision is directly contrary to the decisions being reviewed herein, the Tax Court stated:

> "A partnership, as such, is not a taxpayer under the federal tax law; it is not a taxable entity. The general rule is that *an individual partner is deemed to own a share interest in the gross income of the partnership.*" (Emphasis added.)

The respondent has recognized this rule in other situations. For example, one of his rulings deals with the application of Section 251 of the Internal Revenue Code to partnership income. That section provides that if eighty per cent or more of the gross income of a United States citizen is derived from sources within a possession of the United States for a specified period, he will not be taxed on such income. The respondent ruled in I. T. 3981 (published at Cum. Bull., 1949-2, 78), that a partner's share of partnership *gross* income is included in his gross income for the purpose of that section. This ruling is so clear in its statement of the principles applying to the problem with which it was concerned, as well as to the question presented herein, that we have included it in full as Appendix "B" to this Brief.

Even more recently the respondent has recognized that same rule in the application of Section 130 of the Internal Revenue Code which limits the deductions allowable for business losses which have exceeded $50,000.00 per year for five consecutive years. In Revenue Ruling 155, (published at Cum. Bull. 1953-2, 180), the respondent has stated:

> "In view of the foregoing provisions of section 130 of the Code, such section applies only to a trade or business carried on by an individual taxpayer. When an individual is a member of a partnership, the partnership business is the individual's business to the extent of his proportion of the interest in such business."

Congress has recognized the rule for which the petitioners herein contend in Section 422(a) of the Internal Revenue Code, which was added by the Revenue Act of 1950. That section defines "Unrelated Business Net Income" which is taxable to an otherwise tax-exempt organization. It provides that such an organization which carries on an unrelated business as a member of a partnership shall include, as a part of its unrelated business income, its share of the *gross* income of the partnership derived from the non-exempt activity.

Since a partner's gross income includes his share of partnership gross income under the foregoing authorities, it follows that a partner states his share of such gross income "in the return" when he sets forth in his individual tax return his portion of partnership net taxable income and refers to the partnership information return for the detailed computation leading to that final figure. This is the method of reporting provided by the Internal Revenue Code, Section 182(c). The partnership information return is incorporated by reference into the individual returns of the partners. Accordingly, a partner states "in the return," within the meaning of Section 275(c), his share of the partnership gross income set out in the information return.

VI.

Congressional Support for Petitioners' Position.

Although we submit that the authorities cited above clearly support the petitioners herein and require the reversal of the Tax Court, one most compelling recent congressional statement should be brought to the attention of this Court.

On March 18, 1954, the House of Representatives passed a bill entitled "Revenue Code of 1954." (H. R. 8300.) On July 2, 1954, the Senate passed its version of the same bill which included some amendments to the bill originally passed by the House. Both Houses of the Congress, however, included a subsection 702(c), which subsections are substantially identical. That subsection provides:

> "(c) Gross Income of a Partner.—In any case when it is necessary to determine gross income of a partner for purposes of this chapter [Senate's version used the word 'title'], such amount shall include his distributive share of the *gross* income of the partnership." (Emphasis added.)

The Committee Reports accompanying the two versions of the bill are also substantially identical in discussing this proposed subsection. The reports state that the proposed Section 702 "represents *no change in current law and practice.*" (Emphasis added.) (House Ways & Means Committee Rept., No. 1357, 83d Cong., 2d sess., p. A221.) They also state as follows:

> "Subsection (c) relates to the determination of a partner's share of the gross income of a partnership. It will be noted that section 61(a), which defines gross income, has been amended by your committee to make clear that a partner's gross income includes his distributive share of partnership gross income. However, under subsection (c), the determination of a partner's share of the gross income of the partnership need not be made anually, but only where the determination of the partner's individual gross income is required for income tax purposes. For example, a partner is required to include his distributive share of partnership gross income in computing his individual gross income for the purpose of determining the necessity of filing a return. A partner's gross income may also be relevant for other tax purposes, such as the application of the provision permitting the spreading of income for services rendered over a 3-year period (section 1301), the amount of gross income received from possessions of the United States, and *the extended period of limitations applicable to deficiencies where there has been an omission of 25 per cent of gross income.*" (Emphasis added.) (Senate Finance Committee Rept., No. 1622, 83d Cong., 2d sess., p. 378.)

This clear statement of congressional understanding of the existing law, including the statement by both committees that it applies as the petitioners herein contend under the present Section 275(c), is a clear indication, in addition to the authorities previously cited herein, that the Tax Court was in error and that its decisions should be reversed.

VII.
Negligence.

The Tax Court sustained the five per cent "negligence penalties" in addition to the deficiencies of two of the petitioners, L. Glenn Switzer and Howard A. Switzer. Since the allegations concerning negligence were first raised by the respondent in an Amendment to his Amended Answer in the cases of these two petitioners, the burden of proof in the Tax Court with respect to these allegations was upon the respondent. (Rules of Practice, The Tax Court of the United States, Rule 32.)

The only evidence presented to the Tax Court by the respondent was:

1. A copy of each of the tax returns filed by the petitioners which provide no evidence of negligence. [R. 69-79.]

2. A stipulation of facts which shows that 1.5 per cent of the partnership gross receipts for 1944 and 3.9 per cent of the partnership gross receipts for 1945 were not included in the reported income. That stipulation also shows that deficiencies of $2,258.86 and $11,074.91 are due from L. Glenn Switzer unless their assessment is barred by the Statute of Limitations, and, similarly, that deficiencies of $809.91 and $3,768.68 are due from Howard A. Switzer unless barred by the Statute of Limitations. Certainly, these

facts do not constitute evidence of negligence. [R. 40-42.]

3. The Notices of Deficiency mailed by the respondent to the petitioners and the reports attached thereto which were offered by the respondent and received in evidence by the Tax Court for the limited purpose of showing the amounts involved and the manner in which the respondent arrived at his conclusion. They were not received as evidence of the truth of the descriptions used by the respondents concerning the income adjustments. [R. 55.] As such, the Notices of Deficiency constituted no evidence of any fact not covered by the Stipulation of Facts.

The Tax Court erroneously found that a *prima facie* case of negligence had been made by the respondent by showing the amounts omitted from income. This, in itself, does not constitute negligence. If it did, every income tax deficiency should be accompanied by a five per cent penalty for negligence.

More than mere bookkeeping errors or bookkeeping methods subject to criticism must appear to establish negligence within the meaning of Section 293(a). [*Wilson Bros. & Co. v. Comm.* (C. C. A. 9th, 1941), 124 F. 2d 606, 611.]

The respondent did not present any evidence indicating that the omission of income did not result from an error in the accounting system, a mistaken conclusion concerning legal rights or a technical question under the tax law, or advice of counsel that the items in question were not includible.

Admittedly, the respondent need not negative every possible reason for the omission of income in making a *prima facie* case of negligence. If the burden of proof means anything, however, it must require more for its satisfaction in this context than a showing that certain items of taxable income were not included in the income reported by said petitioners.

The Tax Court also relied, in sustaining the respondent's claim of negligence, upon the "large" discrepancies between reported and corrected net income of the two individual petitioners. In considering that "fact," the Tax Court was undoubtedly persuaded toward the finding of negligence by its erroneous conclusion concerning the principal question herein involved: whether a partner's gross income includes partnership gross or partnership net income. The percentages of omitted income to reported income, mentioned by the Tax Court in its discussion of the negligence question, indicates that it was considering the percentage in view of its erroneous holding that only partnership net income is included in a partner's gross income.

We may assume that its conclusion concerning negligence would have been different had it properly considered that the omissions of income amounted to 5.32 per cent and 12.96 per cent, instead of 147.01 per cent and 444.01 per cent.

VIII.
Conclusion.

A partner's gross income within the meaning of the Internal Revenue Code and, more particularly, Section 275(c) thereof, includes his share of partnership gross income. Also within the meaning of that subsection, such gross income of the partner is "stated in the return" by him when it is reported in the manner prescribed by the Internal Revenue Code. Section 182(c) provides that, except in special situations otherwise covered, the individual partner's share of the net partnership income, set forth as the final figure on the partnership information return filed on behalf of all of the partners, is to be shown on the individual partner's return. In connection with such reporting on the individual return, the Treasury Form No. 1040 requires that the name and address of the partnership be shown, so that the partnership return can be examined and the correctness of the net income ascertained. The partner, in effect, incorporates by reference the single information return filed on behalf of all of the partners. This is similar to the individual sole proprietor who sets forth on a separate schedule "C" all of the receipts and expenses of his sole proprietorship, and shows on page 2 of his return only the net figure.

Therefore, less than 25 per cent of the income stated in the returns by these petitioners was omitted in either year. The three-year period of limitations under Section 275(a) applies and prevents the assessment of the proposed deficiencies in question. The Tax Court should be reversed with directions to enter judgment for the petitioners.

Irrespective of the conclusion of this Court upon the Statute of Limitations question, the negligence penalties sustained by the Tax Court are erroneous in that they are founded upon a finding of fact totally unsupported by the evidence.

Finally, the long standing rules to be observed in the interpretation of tax laws, as repeatedly and consistently stated by the Supreme Court, should not be overlooked:

> "In case of doubt (tax statutes) are construed most strongly against the Government, and in favor of the citizen."
>
> *Gould v. Gould,* 245 U. S. 151, 153 (1917).
>
> "In any event, we think this is * * * (the interpretation) which must be accepted especially in view of the rule which requires taxing acts, including provisions of limitation embodied therein, to be construed liberally in favor of the taxpayer."
>
> *United States v. Updike,* 281 U. S. 489, 496 (1929).

This rule of interpretation is particularly important in considering an exception to the Statute of Limitations that ordinarily protects a taxpayer from a claim of additional liability for years long past. It is equally important in considering the application of a *penalty* on which the Government has the burden of proof.

Respectively submitted,

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APPENDIX "A".

Statutes Involved.

Section 275(a)

"(a) General Rule.—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period."

Section 275(c)

"(c) Omission From Gross Income.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

Section 293(a)

"(a) Negligence.—If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, except that the provisions of section 272(i), relating to the prorating of a deficiency, and of section 292, relating to interest on deficiencies, shall not be applicable."

APPENDIX "B".

Income Tax Ruling (I. T.) 3981.

Bureau of Internal Revenue

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"Advice is requested whether, for the purposes of section 251 of the Internal Revenue Code, relating to income derived from sources within possessions of the United States, gross income derived by a partner from a partnership consists of his proportionate share of the partnership's gross income or his distributive share of the partnership's ordinary net income.

"It is contended that Supplement F (sections 181 through 190) of Subchapter C of Chapter 1 of the Internal Revenue Code contains provisions which change the nature of the gross income derived by a partner from a partnership so that it consists (with exceptions not hereto relevant) only of his distributive share of the partnership's ordinary net income, and not of gross income such as is contemplated by section 22 of the Code.

"With the exception of section 187 of the Code, none of the sections of Supplement F contains any reference to gross income. Even in section 187, no indication is given that, as the term is there used, gross income is anything other than the items specified in section 22 of the Code.

"Section 29.189-1(a)(3) of Regulations 111 reads in part as follows:

" 'His distributive share of a business ordinary net income of the partnership shall be included by each partner as ordinary business gross income, and of a business ordinary net loss of the partnership as an ordinary business deduction. His distributive share of a nonbusiness ordinary net income of the partnership shall be included by each partner as ordinary nonbusiness gross income, and of a nonbusiness ordinary net loss of the partnership as an ordinary nonbusiness deduction.'

"The sole purpose of section 29.189-1 of Regulations 111 is to interpret section 189 of the Code, a section which deals with the application of section 23(s) of the Code to partnership income. Both the purpose and the language of the regulation are such as to preclude any reasonable contention that it has the objective of prescribing that the gross income derived by a partner from a partnership should consist only of his distributive share of the partnership net income. It is apparent, therefore, that there is nothing in Supplement F which makes any exception or addition to the concept of gross income as set forth in section 22 of the Code.

"The general provisions of the income tax statute, in the absence of specific provisions to the contrary, apply to partnership income as if it were received by the partners without the intervention of the partnership. Although a partnership may generally be considered as a business unit, it is, from the viewpoint of Federal income taxation, a unit only for the purpose of making an information return on Form 1065 (United States Partnership Return of Income). Neither the partnership itself nor the partnership return can insulate the partner from his allocable portion of the partnership gross income. Form 1065 is analogous to certain of the schedules contained in Form 1040 (U. S. Individual Income Tax Return) in which the gross income derived from specified sources is entered and the deductions directly allocable thereto are subtracted, the difference constituting an item of adjusted gross income (*cf.* section 22(n) of the Internal Revenue Code). If, for purposes of Federal income taxation, it is necessary to determine the taxpayer's gross income, the amount of gross income entered in such a schedule. not the amount of adjusted gross income, is controlling. An essential difference between the schedules in Form 1040 and the return on Form 1065 is that the schedules apply to but one return, whereas Form 1065 generally applies to two or more returns. But the individual partner's distributive share of the partnership's ordinary net income is as clearly an item of adjusted gross income as if the computation by which it was arrived at had been set forth on his individual return.

"The requirements of section 251(a) of the Code are based on amounts of gross income as well as sources of gross income. Adjusted gross income does not enter into the calculations made to determine whether the taxpayer is entitled to its benefits. A taxpayer claiming the benefits of section 251, all or a part of whose gross income during the applicable period thereunder was derived from a partnership, must determine, in addition to the sources of gross income, the amount of the gross income of that partnership which is allocable to him and make his calculations accordingly. His distributive share of the ordinary net income of the partnership does not affect this calculation."